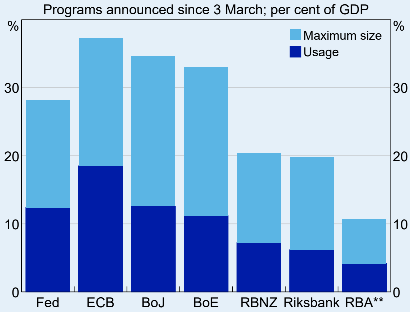
Box C: Central Bank Policy Responses to COVID-19

Central banks responded quickly and forcefully to the economic and financial disruptions brought on by the COVID-19 crisis. As financial conditions began to tighten, central banks rapidly injected liquidity through regular market operations and by reviving emergency facilities launched during the global financial crisis. This was followed by measures to support economic activity, including lower policy rates, new or expanded asset purchase programs, and schemes to support the flow of credit to businesses facing large reductions in income. Most of these facilities have been only partially utilised, in part owing to the easing in financial conditions (which, in turn was aided by the central banks' policies) (Graph C.1). The measures will remain in place for some time to help support economic recoveries. This Box sets out the policies that central banks in advanced economies have implemented since March and outlines the key objectives of each.

Graph C.1

Central Bank Facilities*

Programs announced since 3 March; per cent of GDP



* Includes asset purchase programs (including loan purchases) and term funding schemes; excludes short-term liquidity facilities

** Maximum size assumes no further bond purchases; includes the AOFM structured finance support fund

Source: Central banks

Supporting market functioning and meeting demand for liquidity

During March, critical financial markets became dislocated and threatened to lead to a tightening in financing conditions across economies. These stresses reflected a sharp increase in the demand for liquidity and constraints on the ability of dealers to intermediate markets.[1] Conditions in short-term funding markets tightened significantly and there were unprecedented dislocations in government bond markets, including for US Treasuries.[2]

In response, central banks adjusted their **short-term liquidity operations**. They expanded the volume of funding provided to the financial system through regular market operations and lengthened the maturity at which institutions could borrow. They also eased the terms for accessing backstop funding – lowering the cost, broadening the range of eligible collateral and providing access to a wider range of institutions.

Central banks also purchased a range of assets to restore market functioning. Purchases were largely concentrated in government bonds, given their crucial role in financial markets, but also included private sector assets (Graph C.2). These purchases helped to improve market liquidity at a time when dealers were unable to fully absorb significant one-sided flows.

A number of additional measures were implemented by the Fed with other central banks to meet the heightened demand for **US dollar funding**. US dollars, which play a central role in international trade and finance, had become more expensive to borrow in the foreign exchange swap market. To improve cross-border access to US dollars, the Fed activated, expanded, lengthened maturities and lowered the cost of existing foreign exchange swap lines with central banks, introduced new swap lines with a number of other central banks (including the Reserve Bank of Australia), and introduced a new US dollar repo facility for other foreign monetary authorities.[3]

Reducing risk-free interest rates

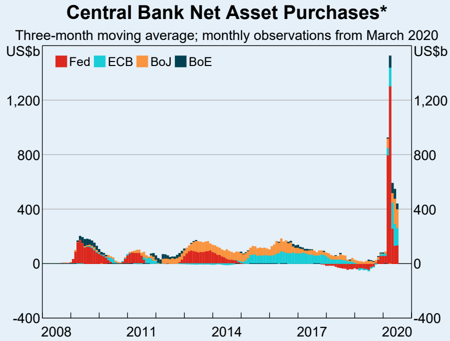
As the economic impact of the pandemic became apparent and global financial conditions tightened in March, many central banks reduced risk-free interest rates in their economies. In the first instance, many central banks in advanced economies lowered short-term **policy rates** to be close to zero. Others with policy rates already at or below zero left their rates as they were prior to the pandemic.

Central banks also introduced or strengthened **forward guidance** for policy rates to remain at their present low levels for an extended period. Many central banks have indicated that policy rates will not rise until the economic recovery is sufficiently progressed ('state-based' guidance). In line with such guidance, risk-free yields have declined to very low levels out to a horizon of several years or more (Graph C.3).

The lowering in risk-free rates can be reinforced with a **yield target**. This is a commitment by a central bank to buy or sell bonds as needed to ensure government bond yields on a particular part of the yield curve remain around a specified level. The Bank of Japan has had a target of around zero per cent on 10-year yields since September 2016. In Australia, the Reserve Bank introduced a target for the yield on 3-year Australian Government bonds of around 0.25 per cent, which reinforces its forward guidance on the cash rate.[4]

Many central banks implemented **asset purchase programs** involving the purchase of particular quantities of government bonds in the secondary market. These purchases have helped to lower long-term risk-free rates, as well as having helped to alleviate severe dysfunction in government bond markets.

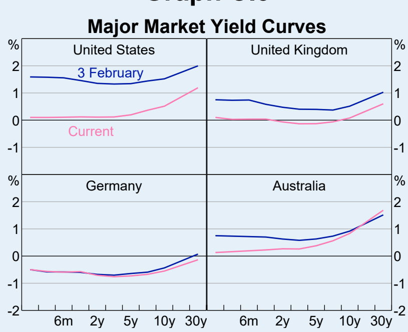
Graph C.2



* Excludes minor operational transactions

Sources: Bloomberg; Central banks; RBA; Refinitiv

Graph C.3



Sources: RBA; Refinitiv

Supporting the flow of funding to businesses

Central banks have implemented programs to support the flow of funding to private-sector borrowers, especially those businesses coming under particular strain. Such programs have operated by supporting either bank lending or market-based funding, with the choice depending partly on the importance of these funding sources in a given economy. In some cases, programs have supported or supplemented government assistance to businesses, such as loan guarantees.

Supporting bank lending

Bank lending has been supported by **term funding schemes.** These schemes provide low-cost, long-term secured funding to banks or other financial intermediaries, which lowers bank funding costs and helps to reduce interest rates for borrowers.[5] These schemes provide incentives for banks to increase their lending to certain borrowers. For example, the Reserve Bank's Term Funding Facility provides one dollar of additional funding to a bank for every dollar increase in credit outstanding to large businesses, and five dollars of additional funding for every dollar increase in credit outstanding to small and medium-sized enterprises.[6]

Supporting market-based funding

Finally, a number of central banks have supported markets in which firms raise funding directly (rather than via banks), by **purchasing corporate debt securities**. Some of these operations have been structured to provide a backstop that is only used when market conditions are quite strained. That said, their mere existence has alleviated market stresses because they provide certainty about the availability of funding at a known price. In other cases, central banks have purchased pre-specified amounts of securities, to promote market functioning and lower funding costs for borrowers.

Buying debt securities effectively involves the central bank lending directly to businesses on an unsecured basis. Accordingly, they involve a greater risk of loss due to defaults than do other types of lending, which are usually secured with collateral. Many central banks have been partly or wholly protected against potential losses on these programs by national governments.

Endnotes

[1] See Debelle G (2020), 'The Reserve Bank's Policy Actions and Balance Sheet', Speech to The Economic Society of Australia, 30 June. Available at: <https://www.rba.gov.au/speeches/2020/sp-dg-2020-06-30.html>. and <https://www.rba.gov.au/speeches/2020/sp-dg-2020-06-30.html>

[2] For details, see RBA (2020), 'International Financial Conditions', *Statement on Monetary Policy*, May, viewed 6 August 2020. Available at <https://www.rba.gov.au/publications/smp/2020/may/international-financial-conditions.html>. and <https://www.rba.gov.au/publications/smp/2020/may/international-financial-conditions.html>

[3] The Fed also launched facilities to alleviate dysfunction in US money markets. These included a new facility to help banks purchase assets sold by money market funds and a facility to purchase

commercial paper to ensure that firms could continue to roll over their debt as it matured.

[4] For further details see Kent C (2020), 'The Reserve Bank's Operations – Liquidity, Market Function and Funding', Speech to KangaNews, 27 July. Available at <https://www.rba.gov.au/speeches/2020/sp-ag-2020-07-27.html>. and <https://www.rba.gov.au/speeches/2020/sp-ag-2020-07-27.html>

[5] See RBA (2020), 'Box A: Term Funding Schemes', *Statement on Monetary Policy*, May, viewed 6 August 2020. Available at <https://www.rba.gov.au/publications/smp/2020/may/box-a-term-funding-schemes.html>. Available at <https://www.rba.gov.au/publications/smp/2020/may/box-a-term-funding-schemes.html>

[6] In the United States, the Fed's Main Street Lending Program is using asset purchases to support intermediated lending. The program allows banks to sell 95 per cent of eligible loans to the Fed, with credit risk to be shared between the Fed and the participating bank in proportion to the ownership share. This aspect of the program is similar to government-funded loan guarantee schemes in operation in other countries.